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Trustee Development Seminar V

“Breaking the Code”

MAPERS Spring, 2016 Conference

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Objective for Trustee Development Seminar V

To provide Retirement System Trustees and Plan Administrators with a general introduction to the Internal Revenue Code ("IRC") and related rules and regulations which apply to governmental retirement systems.

What is Tax Law?

- Internal Revenue Code
- Legislative History
- Cases
- Treasury Regulations
- Revenue Rulings and Revenue Procedures
- Letter Rulings

What is a Qualified Plan?

A retirement plan that satisfies the numerous IRC requirements and therefore is entitled to the various advantages afforded to qualified plans:

- Member does not pay tax on employer contributions until receipt of distribution.
- Member does not pay tax on earnings and income until receipt of distribution.
- Favorable tax treatment upon distribution.
- Employer “pick-up” of member’s required contributions.
- No employment taxes paid on contributions.

What Happens if a Plan is Not Qualified?

- **Tax advantages are not available.**
- **Benefits are subject to taxation.**

What Happens if a Plan Becomes Disqualified?

- **Tax advantages are not available.**
- **Benefits are subject to taxation.**
- **Certain penalties (excise tax) may apply.**

Does a Plan Need IRS Approval to be "Qualified"?

While an IRS Determination Letter is not required, it is valuable certification of proper plan design and administration.

What Constitutes a "Pension Plan"?

IRC § 401(a) Requirements:

•***Written document*** requiring assets to be ***held in trust*** for sole purpose of distributing benefits to members and their beneficiaries.

What Constitutes a "Pension Plan"?

IRC § 401(a) Requirements:

- Definitely determinable benefits
  - Express formula contained in plan.
  - Actuarial assumptions expressed in plan.

What Constitutes a "Pension Plan"?

IRC § 401(a) Requirements:

- Exclusive benefit of employees
  - Payment of benefits
  - Investment of assets
  - No reversion to employer

What is a “Governmental Pension Plan”?

- Plan established and maintained by the U.S. Government or any State or political subdivision.
- A de minimis number of non-governmental employees will not affect tax exempt status.

What Types of Plans Exist?

- Defined Contribution Plans
- Defined Benefit Plans
- Hybrid Plans
- Deferred Compensation Plans
- Welfare Benefits Plan

What Types of Plans Exist?

Defined Contribution Plans

"A plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account."

[IRC § 414(i)].

What Types of Plans Exist?

Defined Contribution Plans

- Contributions which are either discretionary in amount or based upon a specific formula.
- Benefits received are determined by the amount of contributions, investment earnings and forfeitures that are allocated to the participant’s account.

What Types of Plans Exist?

Defined Benefit Plans

"… **any plan other than a defined contribution plan."** [IRC § 414(j)].

What Types of Plans Exist?

Defined Benefit Plans

- Generally, require the employer to provide benefits to plan participants according to a pre-determined formula.
- Payment of definitely determinable benefits to participants over a period of years.

What Types of Plans Exist?

Defined Benefit Plans

- Contributions to the plan depends on actuarial calculations of the amounts necessary to fund the benefits promised under the plan.
- Forfeitures arising under a defined benefit plan may not be allocated to other participants.

What Types of Plans Exist?

Hybrid Plans

Plans which are a hybrid of both the traditional defined benefit and defined contribution plans:

- DB Plans with lump sum options (e.g., Annuity Withdrawal, DROP Plans, etc.);
- DB Plans with fixed or capped Employer contributions;
- Cash Balance Plans.

What Types of Plans Exist?

Deferred Compensation Plans

- Generally, an IRC § 401(a) plan may not include "cash or deferred arrangements" (CODA's) (i.e., plan which allows a participant an election between receiving cash and having an amount contributed to a qualified plan).
- Unless a plan is permitted to maintain a CODA, the entire plan will be disqualified by the existence of a CODA.
- In 1986, Congress amended IRC § 401(k) to prohibit governments from maintaining a 401(K) plan (unless eligible under the grandfather rule).

What Types of Plans Exist?

Deferred Compensation Plans

- Notwithstanding, a governmental employer has the ability to establish an "eligible deferred compensation plan" under IRC § 457 (a "457 Plan").
- permits an employee to annually defer taxes on the lesser of 100 % of includible compensation or $18,000 (in 2016) in contributions made to a 457 Plan.

What Types of Plans Exist?

Deferred Compensation Plans

- Permits an employee to annually defer taxes on the lesser of 100% of includible compensation or $18,000 (in 2016) in contributions made to a 457 Plan.
- Due to the provisions of EGTRRA, limits for 457 Plans are now the same as those for 401(k) plans.
- Deferred compensation plans are not qualified plans under IRC § 401(a), but are eligible for favorable tax treatment on the basis of meeting the requirements of IRC § 457.

Who Must the Plan Cover?

- TRA 97 exempted governmental plans from minimum participation, coverage, and non-discrimination tests.

When Must Pension Benefits "Vest"?

- 100% vesting of accrued benefits upon attainment of plan's normal retirement age.
- 100% vesting if partial or complete termination of plan or discontinuation of contributions.

Employer Pick-Up

Requirements:

1. Employer must specify contributions are being paid in lieu of employee contributions.
2. Employee must not have option to receive amounts picked-up.
3. Pick-ups will not apply retroactively.

Are There Limitations on Compensation?

IRC § 401(a)(17)

- 2016 limit = $265,000
- Compensation in excess of limit may not be used when computing pension benefit.
- Employee contributions may not be computed on more than limit.

Are There Limitations on Contributions or Benefits?

Limits for Defined Benefit Plans

2016 pension benefit "Dollar Limit" = $210,000

1. Dollar Limit is indexed for inflation.
2. Dollar Limit is raised if individual retires later than Social Security retirement age and lowered if individual retires before Social Security retirement age or with less than 10 years of participation.
3. Special Limits for Governmental Plans
    1. No reduction of Dollar Limit unless individual retires before age 62.
    2. TRA 97 allows early retirement of police and fire personnel with reduction in Dollar Limit.

Are There Limitations on Contributions or Benefits?

Limits for Defined Contribution Plans

- Annual amount added to member's account limited to lesser of:
  - $53,000 (in 2016), or
  - 100% of compensation
- Compensation includes wages received, as well as any amounts which are contributed or deferred by the employer and which are not includible in gross income.
- Annual additions is the sum of: employer contributions, employee contributions, and forfeitures.

May a Participant Purchase Service Credit?

Employees’ benefits may be enhanced by allowing purchase of additional service credit with current employer or previous government employer.

- “Permissive service” credit
- Repayments of Cash-outs / Restorations of Service
- Rollovers
- Service Purchase by Employer Pick-Up

What is Permissive Service Credit?

"**Permissive service" credit is any service credit:**

1. Recognized by the governmental plan for calculating a member's benefit.

2. Which the member does not already have credited under the plan.

3. That the member can receive only by an additional voluntary contribution, in an amount determined by the governmental plan, which does not exceed the amount necessary to fund the benefit attributable to this service credit.

However, service will be nonqualified service if recognition of the service would cause the member to receive a retirement benefit for the same service under more than one plan.

NOTE: No more than five years of nonqualified service may be purchased.

What is Nonqualified Service?

"Nonqualified service" is all permissive service except for:

Service (including parental, medical, sabbatical, and similar leave) for the US government, or any state or political subdivision thereof, or any agency or instrumentality of any of the foregoing.

Service (including parental, medical, sabbatical, and similar leave) for an educational organization which is a public, private, or sectarian school which provides elementary or secondary education (through grade 12) as determined under state laws.

Service for an association representing employees of the US, state or political subdivision.

Military service (non-USERRA covered) recognized by the governmental plan.

When May a Plan Make Distributions?

General Rule: member may not withdraw contributions made by employer (or earnings thereon) before normal retirement, termination of employment, or termination of plan.

Members may withdraw their own contributions under limited circumstances:

- Plan amendment to eliminate member contributions
- Member discontinues participation in the plan
- Member may receive plan loan if:

1. Adequately secured;
2. Reasonable interest rate;
3. Repayment provided for in specified time

When is a Plan Required to Make Distributions?

IRC § 401(a)(9) Requirements:

- Distributions must begin by later of April 1 of the calendar year after member attains 70 ½ or April 1 of calendar year after member actually retires
- Nondeductible excise tax may apply if amount actually distributed is less than required amount

IRC § 4974 – Excise tax is 50% of the difference between the required minimum distribution and the actual amount distributed.

May a Plan Make Early Distributions?

- **IRC § 72(t) imposes a 10% excise tax on early distributions from qualified plans. This tax generally applies to distributions paid to members before the member attains age 59 ½. However, exceptions apply to the following types of distributions:**

1. Distributions paid on or after the member's death;
2. Distributions attributable to a member being disabled;
3. Distributions paid in the form of substantially equal periodic payments for life or based on life expectancy;
4. Distributions after separation from service after attainment of age 55;
5. Distributions to a qualified public safety employee who separates from governmental service after attaining age 50 [Pension Protection Act of 2006 (effective August 17, 2006)];
6. Distributions that do not exceed the amount allowable as a deductible medical expense for the member during the taxable year in which the distribution is paid;
7. Distributions to unemployed persons for the payment of health insurance premiums; and
8. Distributions paid to an alternate payee pursuant to the terms of a qualified domestic relations order.

Normal Retirement Age

- On January 27, 2016, the IRS published proposed regulations which identify several safe harbors under which the reasonably representative requirement as applied to governmental plans would be deemed satisfied:
  - A normal retirement age of at least age 62;
  - A normal retirement age that is the later of age 60 or the age at which the participant has been credited with at least 5 years of service;
  - A normal retirement age that is the later of age 55 or the age at which the participant has been credited with at least 10 years of service;
  - A normal retirement age that is the participant’s age if the sum of the participant’s age plus the number of years of service that have been credited to the participant under the plan equals 80 or more; and
  - Any age with 25 years of service in combination with a safe harbor that includes an age.

Normal Retirement Age

- The Proposed Regulations also include three safe harbors specifically applicable to qualified public safety employees only:
  - A normal retirement age of age 50 or later;
  - A normal retirement age that is the participant’s age when the sum of the participant’s age plus the number of years of service that have been credited to the participant under the plan equal 70 or more; and
  - Any age with 20 years of service.

How are Distributions Taxed?

- IRC § 72 requires any amount received as an annuity to be included in gross income.
- Exceptions allow post-tax employee contributions to be excluded from gross income and recovered over the life of the annuity.
- If both pre and post-tax contributions, IRS requires commingling and recovery of post-tax dollars on “pro-rata” basis over the life of the annuity.

What is an “Exclusion Ratio”?

Determines the excludable portion of each annuity payment:

$$\frac{\text{The balance of after-tax contributions to be recovered over the life of the annuity}}{\text{Expected number of payments}}$$

The non-taxable portion of a member’s annuity payment is determined by dividing the “investment in the contract” by the number of anticipated payments based on the primary recipient’s age at the annuity starting date. The member’s “investment in the contract” is the total of all after-tax employee contributions as of the annuity starting date.

Basis Recovery Example:

EXCLUSION RATIO

A.	Annual Straight Life Benefit			$50,000
B.	Accumulated Member Contributions			
	(1) After-Tax Contributions			$22,000
	(2) Interest and Other Non-Taxed Contributions			$30,000
	(3) Total			$52,000
C.	Type of Annuity (single or multiple life)		Single	
	Date of Birth		05/01/1966	
	Effective Date of Retirement		05/01/2016	
	Age Last Birthday		50	
D.	Contributions to be Recovered Over a Period of Years [B(1)]			$22,000
E.	Number of Months for Recovery of Member Contributions (From IRS Table)		360	
F.	Monthly Pension Excludable From Tax	[D ÷ E]		$61.11
G.	Annual Pension Excludable From Tax	[F × 12]		$733.33

Monthly Pension Payment Received on and after 05/01/2046 Will Be 100% Taxable.

The Constructive Receipt Doctrine

- For federal tax purposes, **the doctrine of constructive receipt** provides that a taxpayer can be liable for income, which has not been physically received, but has been credited to the taxpayer's account or otherwise becomes available for him or her to draw upon in the future.

- “Income although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise *made available* so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is *not* constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.” Treas. Reg. Section 1.451-2(a) (1994) [emphasis added].

What is a Rollover?

IRC § 401(a)(31) requires plans to permit members to pay otherwise taxable distribution to an eligible retirement plan.

Eligible Rollover Distribution means:

- One of a series of substantially equal periodic payments
- Any minimum required distribution
- Portion of any distribution not includible in gross income

What is a Rollover?

- “Eligible Retirement Plans”
- Regular Rollover
- Direct Rollover
- Rollover Notice Requirements

What are the Plan’s Withholding Requirements?

- Generally, distributee has option to elect no withholding, but 20% must be withheld from eligible rollover distributions if not paid as “direct rollover”.
- Plan administrator must withhold 10% from non-periodic distributions that don’t qualify for rollover.
- Administrator must withhold as if distributee were married with three exemptions if paying periodic payment that doesn’t qualify for rollover, unless distributee elects otherwise.

How are Duty Disability / Death Benefits Taxed?

- IRC § 104(a)(1) excludes from gross income benefits paid under “statute in the nature of a workmen’s compensation act.”
- IRC § 104(a)(1) does not apply if benefit determined using age, length of service, or prior contributions.
- IRC § 104(a)(1) does not apply to benefits received for non-occupational injury.
- TRA 97 provides death benefit exclusion for “public safety officers’ killed in line of duty.

Are There Investment Limitations for Qualified Plans?

IRC § 401(a)(2) requirements:

- All assets in “qualified plan” must be used for exclusive benefit of employees or beneficiaries.
- Investments must be made for exclusive benefit of members or beneficiaries.
- If assets are employer securities (e.g., governmental bonds), full disclosure required to adhere to exclusive benefit rule.

Are There Investment Limitations for Qualified Plans?

Exclusive Benefit Test:

- Cost must not exceed fair market value @ time of purchase.
- Fair return commensurate with prevailing rates.
- Liquidity must be maintained to permit required distributions.
- Prudent investor safeguards and diversity criteria must be satisfied.

Are There Investment Limitations for Qualified Plans?

IRC § 503(b) prohibits transactions in which the plan:

- Lends income or assets without adequate security and reasonable rates to disqualified person.
- Pays unreasonable compensation to disqualified person.
- Makes any part of its services available on preferential basis to disqualified person.
- Makes substantial purchases/sales for more/less than adequate consideration from/to disqualified person.

What is a Qualified Governmental Excess Benefit Arrangement?

A QGEBA is a portion of a governmental plan if:

- The portion is maintained solely to provide “excess benefits”.
- Participants cannot elect to defer compensation.
- Excess benefits are not paid from trust that is part of governmental plan unless trust is maintained for such sole purpose.

May a Domestic Relations Order Affect the Taxation of Pension Benefits?

- For governmental plans, a DRO will be treated as a QDRO if it "creates or recognizes the existence of the alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under the plan."
- To be a DRO, the order must relate to child support alimony, or marital property rights made pursuant to a State domestic relations law.

Are there IRC Provisions from which Governmental Pension Plan are Exempt?

- **Code § 401(a)(3) -** Requires minimum participation standards and coverage requirement tests to be met.
- **Code § 401(a)(4) -** Prohibits contributions, benefits, optional forms of benefits and other plan features from discriminating in favor of highly compensated employees.
- **Code § 401(a)(10) & 416 -** Top-Heavy Provisions
- **Code § 401(a)(11) & 417 -** Joint and Survivor Annuities. Requires qualified joint and survivor annuity benefits to be payable at retirement and preretirement survivor annuity benefits to become payable upon death prior to retirement.

Are there IRC Provisions from which Governmental Pension Plan are Exempt?

- **Code § 401(a)(12) & 414(l) -** Requires accrued benefits to be preserved when there is a plan merger, consolidation or transfer of assets.
- **Code § 401(a)(13) -** Prohibits assignment or alienation of benefits.
- **Code § 401(a)(14) -** Requires commencement of benefits to be no later than 60 days after the close of the plan year in which normal retirement (or age 65, if earlier), 10th anniversary of participation or termination occurs, whichever occurs later.
- **Code § 401(a)(15) -** Prohibits the reduction of retiree benefits due to increases in Social Security benefits after retirement.
- **Code § 401(a)(19) -** Prohibits accrued benefits derived from employer contributions to be forfeited as a result of withdrawal of employee contribution when such employee is at least 50% vested.

Are there IRC Provisions from which Governmental Pension Plan are Exempt?

- **Code § 401(a)(20) -** Allows qualified total distributions to be made with appropriate notice to PBGC when a plan is terminating.
- **Code § 401(a)(26) -** Code § 401(a)(26) generally requires that for each day of the plan year, the plan must benefit the <u>lesser</u> of 50 employees or 40% or more of all of the employer’s employees.
- **Code § 401(m) - I**ncludes special nondiscrimination tests that apply to employer matching contributions to defined contribution plans. This would generally not apply for public safety plans.
- **Code § 403(b)(12)(A)(i) -** Code Section 403(b)(12)(A)(i) set forth nondiscrimination requirements for those plans which received contributions not made pursuant to a salary reduction agreement.

Are there IRC Provisions from which Governmental Pension Plan are Exempt?

- **Code § 410 -** Requires governmental plans to meet pre-ERISA requirements of 401(a)(3).
- **Code § 411 -** Requires minimum vesting requirements to be met which stipulate that a plan may not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees (401(a)(4)), and 100% vesting upon plan or discontinuance of employer contributions (401(a)(7)).
- **Code § 412 -** Requires plans to be 100% vested upon the plan's termination or discontinuance of employer contributions.

Question / Comments

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- *IMPORTANT NOTE: This summary is intended to be informational only and this session is intended to provide a general overview of the subject matter covered. The applicable laws and regulations continue to evolve with amendments through legislative and regulatory actions, as well as court decisions relating to the law. This information should not be considered the rendering of legal, accounting, or other professional services and should not be used as a substitute for consultation with professional advisers.*